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Fact Sheet

Fact Sheet 491

Grain Futures: Questions and Answers

Introduction

Misinformation about the futures markets is commonplace. Some grain farmers are convinced that low prices are the inevitable result of futures markets. Others believe that futures only benefit large commercial farmers, elevators, millers or feeders. Still others consider futures and/or options to be so complex that only a genius could use them effectively. Too many people believe that if the futures markets were abolished, grain farmers would be much better off.

This misinformation, if not recognized, can prevent good grain farmers from being good grain marketers. Grain marketers need accurate information to enable them to make informed decisions. This fact sheet dispels wrong beliefs about the futures markets and answers some commonly asked questions about them. Since options on futures contracts are closely related to the futures markets, they are discussed here also.

Some Common Questions

What Is Traded on Futures Exchanges?

Commitments to deliver or to accept delivery of grain are traded on futures exchanges. Grain is not traded; in fact, only a small proportion of grain actually changes hands. Most commitments are satisfied with offsetting positions. For example, an initial seller of a futures contract offsets a position by buying the same futures contract before delivering the actual grain. An initial buyer of a futures contract offsets a position by selling the same futures contract.

In the options markets, commitments are similarly traded. However, an options buyer has the "option" of fullfilling his or her commitment. The options seller is committed and hence, does not have the option of fullfilling his or her commitment. Most options contracts either will expire because there is no financial incentive for the buyer to exercise the option, or will be satisfied with offsetting positions.

What are the benefits?

The futures and options markets allow producers and other grain handlers to shift the risk of adverse price movements to someone else—generally, the speculators. Since futures and options contracts are traded as much as 15 months in the future, they also offer the advantage of extending the marketing year.

The futures markets offer one of the best indicators of future price movements. Prices quoted in the futures markets are the equilibrium consensus of what grain buyers and sellers believe prices will be at varied points in the future. Unlike many price forecasters and consultants, these buyers and sellers are willing to put their money behind their market opinions. Research has shown that futures quotes are not that accurate as a forecasting mechanism, but are as accurate as most highly paid consultants and sophisticated forecasting tools. Since futures quotes are widely available, they should be followed closely.

Are speculators needed?

Since grain hedgers are often sellers of futures contracts or buyers of put options, speculators are needed to provide liquidity to the market. Without speculators, farmers could have difficulty selling a futures contract or buying a put. Speculators provide a legtimate economic function by accepting the price risk which farmers and other grain hedgers shift through hedging.

Who uses the futures markets?

With the exception of farmers, most grain handlers directly or indirectly use the futures market. An elevator manager offers a forward contract because he or she usually hedges the contract in the futures market either directly or through another contract with a terminal elevator. The terminal elevator, in turn, hedges directly with a futures contract. Most grain handlers consider the grain markets too risky to not hedge purchased grain.

Some farmers use the futures and options markets directly. These farmers, who are also likely to be good grain marketers, have increased the number of marketing alternatives and have lengthened the marketing year. They also have increased the potential to receive a higher price for their grain and have reduced risk. Many observers argue that more farmers should use the futures and options markets. Certainly, an adequate understanding of the futures and options markets is an essential ingredient to becoming a good grain marketer.

Are the futures markets competitive?

The futures and options markets are as competitive, if not more so, than the cash grain markets. While few observers would argue that the futures or options markets are perfect, there has been no evidence of widespread abuse. Because of the large number of contracts traded, no single trader has the power to manipulate the markets for long periods of time. Abuses, when they have been found, have been isolated to a few unscrupulous floor brokers who gave preferential treatment in filling orders. In general, one would have to conclude that the futures and options markets are as fair as other markets, and more fair than some.

Who regulates the futures and options markets?

The Commodity Futures Trading Commission (CFTC) is the primary federal agency which has responsibility for ensuring fair trade and orderly growth in the futures and options markets. The CFTC complements the extensive self-regulation of the exchanges themselves and the varied set of state laws.

Do the futures markets determine cash prices?

Prices in the futures markets and cash markets are interrelated, with causality moving both directions; that is, futures prices influence cash prices and vice versa. A local markets cash bid and forward contract prices are primarily determined by the futures markets. But since futures market prices reflect the aggregate expectations of grain traders regarding future cash prices, the total grain market determines futures prices. Hence, grain futures and cash prices are jointly determined.

Have the futures markets increased cash market volatility?

To date, research has not conclusively demonstrated the impact of the futures markets on cash market volatility. When the Chicago Board of Trade began in 1848, cash grain prices were wildly volatile. At that time, introduction of futures contracts significantly decreased cash price volatility. Today, the impact on the volatility of cash prices is less certain. Certainly, the futures markets allow the cash markets to function in a more orderly manner which would decrease volatility. However, the reaction of the futures markets to unproven rumors increases short-term volatility. Additional research is needed to answer the question concerning the impact of the futures markets on cash market volatility.

Do the futures markets cause lower cash prices?

There is no evidence that the futures markets cause lower cash prices. In fact, there is some evidence which indicates that the futures markets decrease marketing costs for the grain marketing system. To the extent that they do, futures markets have a positive impact on cash prices.

Are futures and options markets too complex for farmers to use?

The futures and options markets are not too complex for farmers to use. However, just as a farmer would not recommend that a novice attempt to grow corn, wheat or soybeans without becoming familiar with production technologies, it is just as unwise for farmers or anyone else to use more sophisticated marketing techniques without gaining the knowledge to use the techniques effectively.

Can farmers use the futures markets effectively?

Market-knowledgeable farmers, who are willing to invest some time in marketing, can use the futures and options markets effectively. Research has demonstrated that farmers can increase their average returns and reduce their risk through effective use of the futures and/or options markets. Simple, but effective marketing strategies have been specifically developed for farmers.

Do you need a large farming operation to use the futures markets?

There is no reason why a grain farmer who normally has $10,000 in annual sales of any commodity traded on an exchange, cannot use the futures markets directly. The Mid-American Exchange offers minicon-tracts on most grains which are smaller than contracts offered on the Chicago Board of Trade. The correlation of prices quoted on the Chicago Board of Trade and the Mid-American Exchange is very high. Even farmers who do not have $10,000 in sales, can benefit by following the futures and options market, although they probably would not want to use the futures and/ or options markets directly to hedge their crops. A farmer does not need a huge commercial operation to make use of the futures and options markets.

Should the futures and options markets be abolished?

No serious scholar of the futures and/or options markets recommends abolishment of these markets. They provide for more orderly marketing in the cash markets and allow producers to increase returns while reducing risks.

With the futures markets, prices can be locked in subject only to basis risk. Basis risk is much less than price risk. The marketing year can be extended from a few weeks to as long as 15 months. Commissions are normally reasonable, and relatively low margin requirements make it easy to use.

With options, a producer can establish a minimum price that he or she will receive for marketed grain. If prices increase later, the producer using options will still profit from much of the increase. Unlike futures, purchasers of options do not have to deposit margin money, and there are no margin calls.

Hence, options allow the grain producer to purchase insurance against adverse price movements.

If the futures and options markets were abolished, the availability of forward contracts offered by local elevators, processors and feeders would be in danger. If agribusinesses currently offering forward contracts could not hedge their price risk, they may choose not to offer contracts. Abolishment of the futures and options markets would hurt grain producers. They would have fewer marketing alternatives available, which would significantly increase the difficulty of marketing their grain effectively.

Summary

This fact sheet has attempted to banish some of the misformation widely circulated about the futures and options markets. In doing so it has tried to answer many of the most commonly asked questions.

The futures and options markets are beneficial to grain farmers. An individual producer does not have to have a huge commercial operation to make use of them. They are not too complex to use and can be used effectively by agricultural producers. The grain farmer would be much worse off if the futures and options markets did not exist. However, to take full advantage of the opportunities offered by the futures and options markets, an individual producer needs to become knowledgeable and be willing to commit sufficient time to marketing.

This Extension fact sheet is one in a series of grain marketing fact sheets. The series is designed to cover many topics essential to effective grain marketing. Other fact sheets in the series are:

FS 484 Developing a Grain Marketing Plan
FS 485 Grain Marketing: Using Balance Sheets
FS 486 Grain Marketing: Helpful Hints
FS 487 Grain Marketing: Storage Decisions
FS 488 Grain Marketing: The Futures Market
FS 489 Understanding Grain Basis
FS 490 Grain Marketing Alternatives
FS 492 Grain Marketing: Using Options
FS 493 Evaluating Grain Marketing Alternatives
FS 494 Crop Pricing Summary
FS 495 Maryland Corn: Historical Basis and Price Information
FS 496 Maryland Soybeans: Historical Basis and Price Information
FS 497 Maryland Wheat: Historical Basis and Price Information
FS 498 Producers' Guide to Grain Marketing Terminology

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